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Summary

¶1. (SBU) The Salvadoran economy grew 4.2 percent in 2006, ending a six-year streak of anemic economic growth. President Saca has expanded on the sound economic policy of his predecessors to implement a sectoral growth strategy that positions El Salvador as a logistics hub in the medium term, with agriculture, tourism, and full-package apparel assembly (maquila) pushing growth in the short term. He has expanded social services through the creation of FOSALUD, a network of public health clinics, and Red Solidaria, a poverty alleviation program. Both CAFTA-DR implementation and the recently approved MCC compact are also important components of Saca's strategy on economic and social issues. However, maintaining economic growth and alleviating poverty in the run-up to 2009 elections will require new investment, which in years past has been deterred by the security situation as well as regulatory and competition issues, El Salvador's limited domestic market, and a lack of small business financing. End summary.

GDP up 4.2 Percent in 2006

¶2. (U) Showing signs of life after six years of growth that never exceeded 2.8 percent and was as low as 1.7 percent, the Salvadoran economy grew 4.2 percent in 2006, according to the Central Bank. The agricultural sector led the way in 2006, growing 7.1 percent. Other leading sectors were transportation and communication, which grew 5.3 percent, and services, which grew 4.9 percent. Industry and manufacturing grew 3.2 percent in 2006 according to the Central Bank, despite a 10.1 percent contraction in the apparel assembly (maquila) subsector. For 2007, the Saca Administration projects growth of 4.5 percent. Meanwhile, the results of a Ministry of Economy household survey released in December 2006 suggest that there has been little recent progress on poverty alleviation, with 35.2 percent of households living in poverty, up from 34.6 percent in 2004. Overall, there has been good progress on poverty alleviation since the Peace Accords were signed in 1992, when the poverty rate was 58.7 percent

¶3. (U) Annual inflation in 2006 was only 4.3 percent, thanks to dollarization and fiscal discipline that kept the government deficit at 2.7 percent of GDP. Interest rates also remained low, with banks lending at an average of 7.6 percent annual interest for a one-year period. Remittances continued to grow in 2006, increasing to $3.3 billion from $2.8 billion the previous year. Imports were up 13.1

percent for the first 11 months of 2006, reflecting higher fuel prices as well as increased imports of consumer goods. Exports, meanwhile, grew 4.3 percent over the same period.

Saca Making Good on Economic Agenda

¶4. (U) In a marked departure from the strictly laissez-faire economic policies of his ARENA predecessors, after taking office in June 2004 President Saca announced an economic growth strategy that bet on El Salvador becoming a logistics hub in the medium term, with agriculture, tourism, and full-package apparel assembly (maquila) pushing growth in the short term. He also continued the efforts of previous governments to facilitate private-sector-led growth, especially through CAFTA-DR implementation.

¶5. (U) The Saca Administration has made considerable progress in carrying out that agenda. Infrastructure improvements to become a logistics hub are already underway, including construction of a $169 million port in La Union that can handle post-Panamax ships; construction will be completed in 2009. There are also plans to build a new cargo facility at Compalapa airport that would build on TACA's already large passenger hub and cement El Salvador's leadership in regional aviation. Another important infrastructure improvement is the road funded by the Millennium Challenge Corporation (MCC) to be built across the northern part of the country. Customs officials are also moving forward with USAID funded CAFTA-DR reforms to speed cargo handling (Ref. G).

¶6. (U) Growth in the agricultural sector has benefited from a Ministry of Agriculture program to provide farmers with improved seeds for basic grains, but more important factors in 2006 were good weather, higher prices for sugar and coffee, and expanded cultivation of fresh fruits and vegetables. Tourism, meanwhile has received a boost from a new tax exemption for investments in that sector (Ref. I). The private sector has responded by adding nearly

1,000 new hotel rooms, and the Tourism Ministry reports that tourist spending is up 37 percent. Apparel assembly (maquila) has not fared as well, however, and exports have fallen 10.8 percent during the first 11 months of 2006 compared to 2005, due in part to sourcing difficulties triggered by CAFTA-DR's staggered entry into force but also due to increased competition from China (Ref. E).

¶7. (U) CAFTA-DR entered into force for El Salvador and the United States on March 1, 2006. The Saca Administration views the agreement, and its open-market trade policy, as a critical element of El Salvador's economic growth strategy. The agreement has been important to maintaining apparel assembly (maquila) investment in the face of Chinese competition, and it is already paying dividends for exporters of processed foods, sugar, and ethyl alcohol (Ref. D). Officials at El Salvador's export promotion agency, EXPORTA, are confident investors will take advantage of opportunities in other sectors within the next few years. Perhaps as important as the trade benefits are the opportunities for institutional strengthening, especially in the area of investment dispute resolution, intellectual property rights, customs administration, and labor and environmental law enforcement.

Follow Through on Social Agenda as well

¶8. (U) After taking office, President Saca promised an expansion of social programs, signaling a more direct role for the government in poverty alleviation efforts. To a large extent he has followed through on that promise. Three initiatives stand out--FOSALUD, Red Solidaria, and the MCA Compact. FOSALUD, the Solidarity Fund for Health, was launched in December 2004 to extend basic healthcare services to underserved populations and ease overcrowding in national hospitals (Ref. J). Funded by a sin tax that raised about $20 million in 2005 and as much again in 2006, FOSALUD has opened 105 clinics to date.

¶9. (U) Red Solidaria, the Solidarity Network, is a poverty alleviation program launched in March 2005 to provide assistance in the poorest 32 municipalities in El Salvador, all of which have poverty rates of above 50 percent (Ref. F). Families participate in

public health programs and enroll their children in school in exchange for direct monetary support of $15-20 month. Red Solidaria is also improving basic infrastructure such as water, roads, electricity, and housing. The final component includes projects to improve agricultural productivity and to support microfinancing. Although funding has been in question thanks to ostensible FMLN concern that a World Bank loan in support of the effort would further indebt the government (Ref. C), Red Solidaria has now begun working in all 32 targeted municipalities, providing support to an estimated 24,000 families.

¶10. (U) Early in his term, President Saca recognized the significant role the MCC could play in developing El Salvador's northern zone. On November 29, 2006, the Government of El Salvador and the Millennium signed a five-year, $461 million compact that seeks to stimulate economic growth and reduce poverty in the country's northern region. The 291 kilometer northern road is the focus of most headlines, but MCC will also build 240 kilometers in connecting roads and support rural electrification, water sanitation, vocational training, and business development (Ref. A).

Comment: Challenges and Opportunities

¶11. (U) President Saca has expanded on the sound economic policy of his predecessors to implement a sectoral growth strategy and expand social services--while maintaining fiscal discipline. This year's 4.2 percent growth suggests that strategy is paying off, but El Salvador needs new investment to maintain this positive momentum and ensure that the benefits of growth are broadly distributed to address poverty. In 2006, there was negligible foreign investment inflow--the only exception was a Guatemalan bank's purchase of Banco Americano, a failing local bank. Gross capital formation, a measurement of overall investment, was only 15.2 percent in 2005, the lowest in the region.

¶12. (SBU) Several factors explain the lack of investment in El Salvador. Violent crime, which President Saca appears ready to address, is the most significant deterrent to new investment, and it poses enormous costs for businesses already in operation (Ref. H). One large U.S. investor may open a plant that would employ up to 6,000 Salvadorans, but the firm has lingering concerns about security. Ongoing regulatory uncertainty in the electricity sector and recent calls for price controls in fuel distribution also deter investment.

¶13. (SBU) The small size of the Salvadoran economy and anticompetitive practices in some sectors are other factors that hinder investment. Outside of commercial and residential real estate developments that seek to tap into remittances, local investors are looking beyond El Salvador for new opportunities. Finally, a lack of credit for small businesses also hinders investment. The banking sector continues to undergo significant restructuring as multinationals acquire local banks. We are hopeful that these new banks will bring with them new approaches to dealing with small businesses and also push forward pending legislation to modernize the regulation of the financial sector (Ref. B). Dealing with some or all of these constraints on investment will be key to achieving 4.5 percent growth for 2007 and making additional progress on poverty alleviation, especially before the 2009 elections. End comment.

Butler